Supreme Court of the United States

October Term, 1945—No. 55.

UNITED STATES OF AMERICA and FEDERAL COMMUNICATIONS COMMISSION,

Appellants,

v.

NEW YORK TELEPHONE COMPANY,

Appellee.

BRIEF FOR THE PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, *AMICUS CURIAE.*

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Preliminary Statement.

This brief is filed on behalf of the Public Service Commission of the State of New York, pursuant to subdivision 9 of Rule 27 of the Rules of this Court.

Apart from the interest which the New York Public Service Commission has in common with the commissions of other states and with various federal commissions in the questions of law involved herein, the New York Public Service Commission has a direct interest in this case, since it held hearings jointly with the Federal Communications Commission in this case and issued an order substantially identical with that of the Federal Communications Commission.

A proceeding for the review of the order of the New York Commission has been brought in the Appellate Division of the Supreme Court of the State of New York but the argument thereof has been deferred, pending the decision by this Court in the present case.

The opinion of the New York Commission was made a part of the moving papers upon the motion for summary judgment and is part of the transcript filed in this Court. For the convenience of the Court, ten additional copies of the opinion of the New York Commission have been filed with the Clerk of the Court.

The New York Public Service Commission maintains that its order has independent validity, as an order made in the exercise of its jurisdiction over the accounts of the appellee, a New York corporation engaged principally in intrastate business, under the provisions of Article 5 (§§90 to 103) of the Public Service Law of the State of New York. The transfer of the property by the American Telephone and Telegraph Company* to the appellee at a sum in excess of the A. T. & T.'s net book cost violated an explicit rule promulgated by the New York Public Service Commission, in force at the time of the transaction. It also violated the system of accounts for telephone companies then in force in New York State. However, the validity of the New York order under the specific administrative rules prevailing in New York State will not be elaborated herein. This brief will deal only with the validity of the federal order.

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* Hereafter referred to as A. T. & T.

The Decision of the Court Below.

The court below held in substance that, upon a transfer of telephone property by a parent telephone corporation to a wholly owned subsidiary, it is proper for the subsidiary corporation to set up the property on its books of account at a net book cost in excess of the actual net cost to the parent corporation.

This holding presents the fundamental question of law in which the Public Service Commission of New York State and the commissions of many other states are vitally interested. The holding of the court below places telephone companies in a position different from that of all other public utility companies and exempts them from the rule forbidding intercompany profits between affiliates which this Court has uniformly applied in gas and electric company cases (*Colorado Interstate Gas Company* v. *Federal Power Commission*, 324 U. S. 581; *Pennsylvania Power & Light Co.* v. *Federal Power Commission*, 139 Fed. 2nd 445, cert. denied 321 U. S. 798).

We submit that the decision of the court below is wholly incompatible with the opinion of this Court in the *Colorado* case and that, upon the authority of that case, the judgment appealed from must be reversed.

The facts are fully stated in the Government's brief and will not be repeated here.

SUMMARY OF ARGUMENT.

I.

The order of the Commission directing that the intercompany profit be excluded from the net book cost of the property on the appellee's books was proper.

II.

The inflation of the net book cost of the property on the books of the appellee was not eliminated by the subsequent retirement of part of the property.

ARGUMENT.

POINT I.

The order of the Commission directing that the intercompany profit be excluded from the net book cost of the property on the appellee's books was proper.

We agree with the appellee that we are concerned here only with ascertaining the net book cost of the appellee's property, under the system of accounts which became effective on January 1, 1937. However, the net book cost must necessarily be determined historically by an examination of the transaction which gave rise to the figures now on the books. Obviously, if there was a write-up on the books of the company in the past, it must be eliminated and the accounts must be restated at true cost. The appellee would undoubtedly concede that, if the appellee had simply written up property which cost it eight million dollars to twelve million dollars, the four million dollar excess would have to be excluded in setting up the books of account on a cost basis and a corresponding charge would have to be made to surplus.

This is equally true if, instead of a simple write-up on the books of one company, the inflated book figure is the result of a transfer between two public utility companies, owned and controlled by the same interests, at a price in excess of the cost to the transferor. The excess over the transferor's cost reflected in the so-called purchase price, in such a case, does not represent actual cost; it does not represent any additional investment in the property.

The setting up of the inflated price on the books of the New York Telephone Company in this case, was improper, since it did not represent true cost or actual investment but was merely a write-up in connection with an intra-family transfer by a parent to a wholly owned subsidiary.

The principle here involved is not dependent upon the "original cost" provisions of the new Uniform System of Accounts which took effect on January 1, 1937. It is inherent in any system of accounting which is concerned with the recording of true investment or actual cost. The important point here is not merely that the inflated price does not represent the original cost to the transferor; the fact is that it does not represent an actual investment by any one.

Obviously, the question of value does not enter into a system of accounts kept on the basis of the cost. As this Court said in *Northwestern Electric Company* v. *Federal Power Commission*, 321 U. S. 119, at page 123:

> "A mere write-up belongs in none of these accounts and cannot properly appear in any other account on the asset side of the ledger. If it should so remain, it would have to be in a new account reflecting present value in excess of actual cost which would, in effect, be a plant appreciation account and the Commission's form of accounting does not permit the carrying of any such item in the asset account since its system is a cost system of accounting."

"Where property is transferred by a parent to a wholly owned subsidiary, there is no more right to enter the property upon the books of the subsidiary, under a cost system of accounting, at a price in excess of the parent's cost, than there is to write up the book cost of property which had been built by the subsidiary. In neither case, is the current value which may be established by appraisal or otherwise of any relevance.

The fact that the New York Telephone Company actually paid the price fixed by the A. T. & T. is in no way inconsistent with the finding that there was no additional investment or increase of actual cost by reason of the transaction. The A. T. & T. owned the surplus of the New York Telephone Company by virtue of its ownership of the common stock prior to the transaction and it continued to own the surplus thereafter. The payment was therefore virtually a payment by the A. T. & T. to itself. It was simply a transfer from one pocket of the A. T. & T. to another pocket. The true nature of the excess payment is made evident by the fact that, in any consolidated statement of the A. T. & T. and its subsidiaries, which may be issued at any time in the future, the increase in the surplus of the A. T. & T. created by the excess payment will have to be eliminated.

Likewise, the A. T. & T., through its ownership of the common stock of the New York Telephone Company, owned whatever equity the New York Telephone Company had in its property and it continued to own such equity after the making of the transfer. If the property transferred to the New York Telephone Company had any greater value at the time of the transfer than the cost to the A. T. & T., the A. T. & T. did not surrender that appreciation by transferring the property to the New York Telephone Company. The increased value would be reflected in the equity of the

New York Telephone Company in its property on a value basis and that equity would in turn belong to the A. T. & T. by virtue of its common stock ownership.

Looked at realistically, the transaction with which we are here concerned is not essentially different from a simple write-up on the books of the New York Telephone Company. If the A. T. & T. had transferred the property to the New York Telephone Company at its net book cost, instead of the inflated price, and then had directed the New York Telephone Company to write up the property to a higher book cost upon the basis of appraised value, and had caused the New York Telephone Company to transfer the "profit" thus created to the parent corporation by way of a dividend, the appellee would undoubtedly concede that the write-up would have to be eliminated from the New York Telephone Company's books. Yet the supposed transaction would not differ in substance from the transaction by which the appellee claims to have created an additional element of cost.

The order here under review requires the New York Telephone Company to disclose the true facts on its books of account and, by a direct charge of the excess payment to surplus, to show that such payment was in effect merely a transfer from its surplus to the surplus of its parent.

There is much said in the appellee's brief about the Interstate Commerce Commission system of accounts which was in force at the time of the transactions in question but, as we read that system, it, too, was a system based upon actual cost and the entry of an inflated figure upon the books of the appellee was inconsistent with the system. The specific provisions of the system upon which the appellee relies seem to us to relate only to an actual purchase, where an additional investment is made, and not to a transfer between a parent company and its subsidiary. In the case of an actual purchase, the system prescribes the method

of recording the purchase price. If the price actually paid is in excess of the so-called structural value, as defined in the I. C. C. system, so much of the price as represents structural value is to be entered in the plant accounts and the rest of the price is to be entered elsewhere. If, on the other hand, the price paid is less than the structural value of the property purchased, the price is to be distributed among the plant accounts in proportion to the structural value of the items of property included in the purchase. In no event is anything to be entered on the books in excess of the actual cost or the actual investment. Since there was no actual investment in this case in excess of the A. T. & T.'s net book cost, there was no justification, under the I. C. C. system, for the entry of any additional sum on the books of the New York Telephone Company.

The I. C. C. system does not purport to prescribe how the so-called price is to be arrived at, upon a transfer by a parent corporation to its subsidiary. It merely prescribes the accounting to be followed in recording whatever price may be fixed. The price is to be fixed by the parties, in accordance with the general principles of law governing public utility companies. It is settled, both under the federal authorities and under the law of New York, the state in which the transactions involved in this case took place, that, upon a transfer of public utility plant by a holding company to its wholly owned subsidiary, the price fixed may not exceed the net book cost of the transferor.

Colorado Interstate Gas Company v. *Federal Power Commission,* 324 U. S. 581;

Pennsylvania Power & Light Company v. *Federal Power Commission,* 139 Fed. (2d) 445; certiorari denied 321 U. S. 798;

New York Edison Company v. *Maltbie,* 244 A. D. 685 at p. 689; affirmed on other grounds 271 N. Y. 103;

Long Beach Gas Company, Inc. v. *Maltbie,* 264 A. D. 496, aff'd. 290 N. Y. 572;
Pavilion Natural Gas Company v. *Maltbie,* 268 A. D. 610;
Citizens Water Supply Co. of Newtown v. *Maltbie,* 267 A. D. 793; aff'd. 293 N. Y. 849.

These cases rest upon general principles of law wholly apart from any administrative accounting rule.

The New York Appellate Division pointed this out, in rejecting a proposed accounting rule, which would have required the writing-off of any payment in excess of original cost, even in an arms-length transaction:

> "The only persuasive argument advanced by counsel for the Commission as to the necessity for the rule was that property purchased by operating or subsidiary companies had been resold to the holding or parent company at an increased price, and this increased and inflated price placed in the fixed capital account of the holding or parent company. The Commission already had control of entries reflecting these wash sales, and the authority to require their elimination from a fixed capital account."
>
> *Matter of New York Edison Company* v. *Maltbie,* 244 A. D. 685, at p. 689.

In the absence of a rule of law such as that laid down by this Court in the *Colorado* case, *supra,* a parent corporation would be free to transfer property to its subsidiaries and to transfer property from one subsidiary to another at will, to reflect rises in the price level or changes in the judgment of appraisers from time to time and, in this way, to inflate the apparent cost of its property, with resulting deception or confusion of the regulatory agencies and the hampering or frustration of effective regulation.

When the I. C. C. system is read in the light of this background, it is apparent that the system was not intended to authorize a transaction of the type here under consideration.

It may be noted that this precise question arose in New York State in 1921, several years prior to the transactions in question, with respect to the interpretation of the New York system of accounts, which was then substantially the same as that of the I. C. C. General Instruction No. 7 of the New York system entitled "Plant and equipment and other property purchased" was substantially the same as §13 of the General Instructions of the I. C. C. system, upon which the appellee relies. On March 17, 1921, the New York Public Service Commission issued an order clarifying Instruction No. 7 by inserting the specific statement that "when there is substantial identity of interest between the vendor and the vendee the value assigned to tangible fixed capital accounts shall not exceed the original cost of such property to the vendor."*

* The instruction, as clarified in 1921, so far as here relevant, read as follows:

> ". . . When any telephone line or part thereof (excepting new or used material and supplies) is purchased for a lump sum, an appraisal of the property so acquired shall be made, classifying the various constituent elements in the property according to the accounts prescribed by this Commission in its Uniform System of Accounts for Telephone Corporations. The actual money value of the consideration given for the plant or other property purchased shall be distributed to such accounts in accordance with the appraisal, but in no case shall the values assigned to tangible fixed capital accounts exceed the cost to reconstruct such plant and equipment at prices in effect at the time of the purchase, *and when there is substantial identity of interest between the vendor and the vendee the values assigned to tangible fixed capital accounts shall not exceed the original cost of such property to the vendor. The estimated accrued depreciation on property purchased shall be set up on the books of the vendee as an offsetting liability to the cost of property so acquired.* . . ." (Italics supplied.)

The New York order was merely declaratory of the basic principle common to the New York system and the I. C. C. system. Both systems were based upon the principle of actual cost. Reasonably construed, in the light of this principle and of the general principles of law applicable to public utility transactions, neither system permitted an increased price upon a transfer from a parent to a subsidiary to be capitalized as an element of cost or as an additional investment.

However, we agree with the position taken by the Government in its brief in this Court that it is not necessary to rest the validity of the order of the Commission here under review upon the ground that the transactions were improper at the time that they took place. Even if it is assumed for the purpose of argument that the write-up was not forbidden by any judicial or administrative rule then prevailing, the fact remains that, as of January 1, 1937, the appellee was required to restate its accounts upon the basis of actual cost or actual investment and, upon that basis, any excess over its parent's net book cost, paid for property transferred to it by its parent, must be excluded from its books of account.

The power of the Commission to require the company to exclude from its net book cost a payment to its own parent in excess of the parent's net book cost rests upon the authority of the Commission to require the company to state its accounts anew on the basis of true cost or actual investment.

If the I. C. C. system is interpreted in accordance with the appellant's contention, then the I. C. C. system was not a cost system of accounting in its entirety but, so far as it applied to intercompany transactions within a single holding company system, it permitted "value" accounting. The permissibility of the original entries under such a sys-

tem is wholly irrelevant in determining what may properly be set up in books which are required to be stated on a cost basis.

In order to bridge the transition from the pre-existing accounts of the company to the accounts required to be set up under the uniform system as of January 1, 1937, the uniform system provides for the segregation and placing in Account 100.4—Telephone Plant Acquisition Adjustment of any sums in excess of the original cost of the property to the person first devoting it to the public service. As this account has been construed in actual application by the Federal Communications Commission and by the state commissions which have adopted similar provisions in their respective systems, this account is properly called into operation only in connection with an actual purchase from an outside interest, where the purchase price in part represents an additional investment above that originally made by the prior owners of the property. However, this account is sometimes used as a temporary resting place for an excess payment made to a parent corporation or to an affiliate within a single holding company system, prior to its being charged off to surplus. The use of the account in such a case is merely a matter of mechanics, because the charge to surplus follows immediately. A direct charge to surplus seems to us to be simpler and more easily understood; that is the course which the Commission adopted in this case.

It may be noted in this connection that the system of accounts adopted by the Federal Power Commission for electric corporations has an Account 107, entitled "Electric Plant Adjustments," in addition to an Account 100.5 "Electric Plant *Acquisition* Adjustments." The former account is used for the elimination of write-ups either of the simple one company type or of the two company type involved in

this case, where there is no true purchase and hence no "acquisition" adjustment to be made. Under the telephone system, Account 100.4 may be used to serve the function of Account 107 of the Federal Power Commission's system or a direct charge to surplus may be used instead.

When Account 100.4 is used to serve its primary function, in connection with true purchases from outside interests, the items segregated in Account 100.4 are not earmarked to be written off against surplus but are held for subsequent consideration, with a view to amortization or other disposition in accordance with the facts disclosed upon hearing or investigation. However, when the account is used in connection with a transaction of the kind here involved, there is no question of an additional purchase price actually paid to outside interests or of any additional investment in excess of the vendor's cost and hence there is no need for further consideration.

The appellee concedes that, at least as to the surviving property, the excess of the price charged the appellee by the A. T. & T. over the A. T. & T.'s net book cost should be placed in Account 100.4. However, the appellee advances no persuasive reason for allowing such excess to remain in Account 100.4 indefinitely or for refusing to charge it off at once against surplus. In view of the holding by this Court in *Colorado Interstate Gas Company* v. *Federal Power Commission*, 324 U. S. 581, such excess cannot be recognized as a true element of cost. It therefore has no place in books of account intended to reflect true cost or actual investment.

POINT II.

The inflation of the net book cost of the property on the books of the appellee was not eliminated by the subsequent retirement of part of the property.

In its brief in this Court, the appellee seeks to sustain the order of the court below upon a ground not mentioned in the opinion of the court, although it had been urged upon the court by the appellee.

The appellee contends that the inflation of the net book cost has been in part eliminated by the retirement of part of the property by charges to the Depreciation Reserve.

In examining this contention, it should be borne in mind that the net book cost consists of two factors: the book cost of the property entered on the asset side of the company's accounts and the related depreciation entered in the Depreciation Reserve on the liability side. It is the difference between these two figures which constitutes the net book cost. A write-up or inflation of net book cost may be brought about either by an inflation of the book cost figure on the asset side or by a reduction of the related depreciation figure on the liability side.

In this case, the inflation was accomplished principally by an understatement of the related depreciation. Taking the total figures, the entry on the asset side was \$12,634,680.38. This figure happened to be somewhat less than the actual cost of the property new on the books of A. T. & T ($13,269,567.47). However, on the books of the A. T. & T. there were related depreciation reserves (as determined by the A. T. & T. itself) of \$4,801,397.66, thus leaving a net book cost on the A. T. & T. books of \$8,468,169.81. Upon recording the transfer on its books, the appellee made no entry in the Depreciation Reserve

at all, thus making its net book cost $12,634,680.38, or an inflation in net book cost over the net book cost of the A. T. & T. of $4,166,510.57. This is the "profit" on the transaction which went into the Surplus of the A. T. & T.

The omission of the related depreciation reserves thus created an inflation of the net book cost of the property of about $4,000,000.

In view of the manner in which the inflation of net book cost was brought about, it is obvious that the subsequent retirement of the property could not cure the distortion of the accounts. Assuming that the annual depreciation charges relating to this property were subsequently accrued at the standard rates of depreciation used by the appellee, there could not be a sufficient sum in the depreciation reserves to absorb the whole book cost of the property upon its retirement. There would be in the reserves only so much as was subsequently accrued by the annual charges; the initial omission of the depreciation accrued to the time of the transfer would remain unaffected and the depreciation reserve would still be understated by that amount. Since the depreciation reserve would be debited with the whole book cost of the property upon its retirement, the depreciation reserve would be depleted to the extent to which the book cost exceeded the amount of the related depreciation accrued in the reserve. After the retirement of the property, it is true that the property would no longer be reflected on the asset side of the accounts but the original distortion of net book cost would remain. The original deficiency in the related reserve would simply be transformed into a depletion of depreciation reserves which had been accumulated by the company for the purpose of covering the retirement of other property.

The order under review here eliminates this distortion of the accounts by directing a transfer of about $4,000,000 to the depreciation reserve and a corresponding debit to surplus.

Upon analysis, it will be seen that the order does not purport to review the adequacy of the depreciation reserve as a whole nor does it deal with the depreciation practices of the appellee. The fact that the appellee uses a group method of computing depreciation has no relevance here. The order deals solely with the elimination of a write-up of net book cost. Since the write-up consisted of an omission of a credit to depreciation reserve, it must necessarily be corrected by a direction to transfer the appropriate amount from surplus to the depreciation reserve.

The appellee's principal argument in this connection seems to relate to the procedure by which its accounts are to be corrected rather than to the merits of the Commission's order. The appellee argues that, after the retirement of the property, the distortion of the appellee's accounts which resulted from the transaction may no longer be corrected by a specific order of the Commission directed to that end, but may be corrected only in connection with a general investigation of the depreciation reserves of the appellee. No plausible reason is advanced for thus restricting the Commission's power and preventing it from dealing with each specific transaction as the facts with respect thereto come to light. Clearly, the Commission has the right to root out an improper entry and to follow it through to all of its consequences in the accounts of the company. Since the distortion is reflected in the depreciation reserve, the Commission has the right to direct the

appropriate correction of that account without undertaking a general investigation of the adequacy of the account as a whole.

If the appellee's view were accepted, no correction could be ordered by the Commission unless the Commission was prepared to establish that the account to which the correction relates is in all other respects correct and that there is no offsetting element in the account which might tend to neutralize or mitigate the effect of the particular distortion.

The argument which the appellee makes on this point could be advanced with equal relevance in connection with a simple one company write-up of an item in the asset accounts; its unsoundness in such a case makes evident its unsoundness in this case. For example, if the book cost of an item of property had been written up on the asset side, the appellee would argue that the Commission was powerless to correct the write-up until it had examined all the other items in the plant account to determine whether perchance there was some understatement in some other unrelated transaction which might offset the write-up. Such a contention would clearly be untenable.

It is suggested by the appellee that the annual accruals to depreciation reserve which it made during the period from 1925-1928 to January 1, 1937, not only took care of the currently accruing depreciation but also made up for the omission of $4,000,000 of accrued depreciation in the initial entries in connection with the property here in question. This is a startling argument for a regulated public utility to offer as a ground for refusing to correct a write-up. In effect, the argument amounts to this: that during the period in question, the appellee charged as part of its operating

expenses an excessive amount for the depreciation accruing during the period and that this excess was large enough to offset the write-up so that its net book cost on January 1, 1937, is the same as if there had been neither a write-up nor excessive depreciation accruals thereafter. On its face, the excuse would seem to be worse than the act sought to be excused. If any such practice were followed, it was certainly unfair to the consuming public whose rates were based upon the operating expenses, including the annual depreciation charges, and it was certainly misleading to the regulatory agencies.

In any event, the record clearly sustains the conclusion of the Commission that no subsequent depreciation accruals were made for the purpose of offsetting the write-up. It should be borne in mind that the total book cost on the asset side, which is the base to which the rates of depreciation are applied in computing annual depreciation, was not in excess of, but in fact was somewhat less than, the actual cost of the property new. Therefore, no amortization of the write-up resulted from the application of the standard rates of depreciation. There is no evidence that any additional or special charges for depreciation were made directed toward the correction of the distortion of the accounts growing out of the transactions here in question.

In view of the fact that the proof clearly showed that there had been a distortion of the net book cost by the transactions of 1925-1928, the burden of proof rested heavily upon the appellee to establish by clear and convincing evidence that the distortion had been removed or neutralized by subsequent charges or accruals and, if it was claimed by the appellee that the distortion had been partly corrected, the burden rested upon it to establish the exact extent of such correction. This burden of proof was not sustained by the appellee.

There was substantial evidence in the record to support the Commission's conclusion that the distortion had not been corrected to any extent; the conclusion of the Commission on this point must therefore be sustained.

Conclusion.

The judgment appealed from should be reversed.

Respectfully submitted,

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Dated: November 12, 1945.

SUPREME COURT OF THE UNITED STATES.

No. 55.—October Term, 1945.

The United States of America and Federal Communications Commission, Appellants, *vs.* New York Telephone Company.	Appeal from the District Court of the United States for the Southern District of New York.

[January 28, 1946.]

Mr. Justice Rutledge delivered the opinion of the Court.

This case presents new questions of "original cost" accounting, which arise from an order of the Federal Communications Commission requiring readjustments in appellee's accounts. A detailed statement of the facts is necessary to an understanding of the issues. But the short effect of the controversy is that the Commission has required the appellee, New York Telephone Company, to make charges of some $4,166,000 to surplus, with corresponding credits to other accounts; the ultimate effect being substantially to compel the elimination of so-called write-ups from the company's accounts in order to bring them, to this extent, into conformity with the Commission's Uniform System of Accounts, which is based upon "original cost." The attacked entries were made in 1925, 1926, 1927 and 1928, prior to enactment of the Federal Communications Act, upon acquisition by appellee of business and property from its affiliate, American Telephone and Telegraph Company. The case embodies a rather long delayed chapter of the broad controversy presented in *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232, to be discussed later.

For preliminary purposes it is enough to say that the appellee questions the Commission's power to make the order in issue and a District Court, composed of three judges, has permanently enjoined its execution. 56 F. Supp. 932. From that judgment this appeal has followed.

We turn to the facts before undertaking to state the issues more precisely. Appellee, the New York Telephone Company, is a subsidiary of the American Telephone and Telegraph Company, which owns all its common stock. Since its incorporation in 1896 appellee has engaged in the business of furnishing intra-

state and interstate telephone service to the public in the states of New York and Connecticut. Prior to 1925, for historical reasons, American also had furnished intrastate toll service between certain points in New York State; but in that year, as part of its plan to withdraw from all such business, American transferred its intrastate toll business in New York State to the appellee.

In connection with this transaction occurred the four transfers of property, the accounting for which now concerns us. In November, 1925, September, 1926, and December, 1928, appellee purchased from American certain toll plant consisting of property such as poles, crossarms, guys and anchors, aerial wire and cable, underground cable, loading coils, conduit, and right of way. This property was needed to handle the additional intrastate business which had been transferred to it. Much of the property so acquired was in the form of an additional interest in toll plant which, prior to these transfers, had been jointly owned by American and New York.

The fourth sale took place in 1927. Before that time American had retained ownership of three essential parts, collectively called "the instruments"—the transmitter, receiver and induction coil—of the telephone stations used by subscribers. American had furnished and maintained these instruments under a contract between it and New York under which New York paid it a specified percentage of its gross revenues. In December, 1927, American sold to New York the instruments then in the service or supplies of New York.

None of these transfers of property changed the physical character of the plant or the service rendered to the public. The sole effects were to shift certain operating costs of American and certain fixed charges and taxes connected with the ownership of the property to New York and to eliminate New York's obligation to make payments to American for use of "the instruments"; for the rest, as the New York Public Service Commission described the transfer, it was "a bookkeeping transaction, with no change in ultimate ownership, in location, or in use of the . . . property, but reflecting only a revised business relationship between affiliated corporations."[1]

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[1] Opinion of the New York Public Service Commission, Case 9436, adopted December 14, 1943, 1 Report of the Public Service Commission (1943) 569, 571.

American and New York agreed that the purchase price of the toll plant was to be an amount equal to its "structural value." As defined by the Uniform System of Accounts for Telephone Companies (Instruction 13) of the Interstate Commerce Commission, this was "the estimated cost of replacement or reproduction less deterioration to the then existing conditions through wear and tear, obsolescence, and inadequacy." A field inspection and an appraisal of the property were made by engineers, and appellee paid to American a total of $5,973,441.47 for the toll plant. The purchase price of the instruments transferred in 1927 was $6,661,238.91. This was based on the average price charged American by the Western Electric Company, the manufacturer and also a subsidiary of American, during the first nine months of 1927, less a twenty per cent allowance to reflect the then existing condition of the instruments.

The tables set out in the margin show the accounting treatment of these transfers at the time they occurred.[2] As the tables disclose, the "profit" to American, that is, the difference between the net book cost to it and the record book cost to New York, was $4,166,510.57. This amount American credited to surplus accounts as profit on the transactions.

This "profit," of course, arises from the fact that New York in making its accounting entries ignored the original cost to American and the depreciation which had accrued on the books of American up to the time of transfer, and entered solely the actual price paid by it for the properties. It did not, so to speak, "fold in" the net book cost to American.

Having set down these properties on its books at the price it paid to the parent corporation for them, New York then applied what it calls the "group method" of depreciation.[3] Under

Property Group	Book Cost to American	Related depreciation and amortization reserves	Net book cost of American	Recorded book cost to New York	Excess or "Profit" to American
—Toll line Property	$5,010,840.19	$801,858.95	$4,208,481.24	$5,831,884.78	$1,623,403.54
—Toll line Property	95,924.66	14,449.20	81,475.46	97,310.39	15,834.93
—Toll line Property	28,077.64	4,144.78	23,932.86	44,246.30	20,313.44
—Telephone instruments	8,135,224.98	3,986,944.73	4,154,280.25	6,661,238.91	2,506,958.66
Total	13,269,567.47	4,801,397.66	8,468,169.81	12,634,680.38	4,166,510.57

[3] The Federal Communications Commission defines "'Group plan', as applied to depreciation accounting" as "the plan under which the depreciation charges are accrued upon the basis of original cost . . . of all property included in each depreciable plant account, using average service life thereof properly weighted, and upon the retirement of any depreciable property its

this method special depreciation rates were not applied to the property in question, despite the fact that it had a relatively short remaining life. Instead the current depreciation rates applicable to similar classes of plant were applied as long as the property remained in service. As portions of the property were retired, they were written out of the plant account at the amounts at which they had been recorded therein, that is, at the structural value; and debits of corresponding amounts, less allowance for salvage, were charged concurrently to the depreciation or amortization reserve.

On January 1, 1937, the Uniform System of Accounts of the Federal Communications Commission[4] for Class A and Class B telephone companies became effective[5] and applicable to New

full service value is charged to the depreciation reserve whether or not the particular item has attained the average service life." 47 Code Fed. Reg. 31.01-3(p).

[4] The Communications Act of 1934 (48 Stat. 1064) provides:

"Sec. 220 (a). The Commission may, in its discretion, prescribe the forms of any and all accounts, records, and memoranda to be kept by carriers subject to this Act, including the accounts, records, and memoranda of the movement of traffic, as well as of the receipts and expenditures of moneys."

"Sec. 220 (c). The Commission shall at all times have access to and the right of inspection and examination of all accounts, records, and memoranda including all documents, papers, and correspondence now or hereafter existing, and kept or required to be kept by such carriers, and the provisions of this section respecting the preservation and destruction of books, papers, and documents shall apply thereto. The burden or proof to justify every accounting entry questioned by the Commission shall be on the person making, authorizing, or requiring such entry and the Commission may suspend a charge or credit pending submission of proof by such person. . . ."

"Sec. 220 (g). After the Commission has prescribed the forms and manner of keeping of accounts, records, and memoranda to be kept by any person as herein provided, it shall be unlawful for such person to keep any other accounts, records, or memoranda than those so prescribed or such as may be approved by the Commission or to keep the accounts in any other manner than that prescribed or approved by the Commission. Notice of alterations by the Commission in the required manner or form of keeping accounts shall be given to such persons by the Commission at least six months before the same are to take effect."

Prior to passage of the Communications Act the power to prescribe accounts for telephone companies had been lodged with the Interstate Commerce Commission. Interstate Commerce Act § 20(5), 41 Stat. 493, subsequently amended, 54 Stat. 917. See American Telephone & Telegraph Co. v. United States, 299 U. S. 232, 235-236.

[5] The order of the Federal Communications Commission prescribing a uniform system of accounts for telephone companies having average annual operating revenues exceeding $50,000, was adopted on June 19, 1935, 1 F. C. C. 45, and was originally to be effective January 1, 1936. This order was stayed because of the proceeding in the American Telephone & Telegraph Co. case, *supra* note 4, and did not become effective, as amended, until January 1, 1937. 3 F. C. C. 9.

York. Under this system telephone companies were obliged to establish or reclassify their investment accounts on the basis of "original cost."[6]

In reclassifying its accounts as of January 1, 1937, New York estimated the amounts attributable to the surviving toll plant received from American, which it originally had included in its books on the basis of structural value. New York then determined the difference between those estimates and what it estimated was the original cost of such surviving plant to American. The difference was placed in Account 100.4, Telephone Plant Acquisition Adjustment. Account 100.4 includes amounts "representing the difference between (1) the amount of money actually paid (or the current money value of any consideration other than money exchanged) for telephone plant acquired, plus preliminary expenses incurred in connection with the acquisition; and (2) the original cost of such plant, governmental franchises and similar rights acquired, less the amounts of reserve requirements for depreciation and amortization of the properties acquired."[7]

In 1938 New York began amortizing this sum by charges and credits to its operating expense Account 614, Amortization of Telephone Plant Acquisition Adjustment, with concurrent entries to Account 172, Amortization Reserve. As portions of the acquired plant were retired, amounts in Account 100.4 were written out of that account and concurrent entries were made in Account 172.

On June 16, 1942, the Federal Communications Commission instituted the present proceeding by ordering a general investigation into the accounting performed by appellee at the time of and subsequent to the four transfers of property involved in this suit. The order required New York to show cause why $4,166,-510.57 (the difference between book cost to American, less related

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[6] The Rules and Regulations of the Federal Communications Commission provide that "'Original cost' or 'Cost,' as applied to telephone plant, franchise, patent rights, and right-of-way, means the actual money cost of (or the current money value of any consideration other than money exchanged for) property at the time when it was first dedicated to the public use, whether by the accounting company or by predecessors." 47 Code Fed. Reg. 31.01-3(x).

[7] At the same time appellee transferred from its Account 171, Depreciation Reserve, to its Account 172, Amortization Reserve, an amount which, when supplemented by future accruals over the estimated remaining life of the plant at the then current depreciation rates, would provide a reserve equivalent to the amount in question in Account 100.4 at the termination of the life of the property involved.

depreciation, and the structural value of the property as recorded on the books of New York) should not be charged to its Account 413, Miscellaneous Debits to Surplus, with concurrent entries to such accounts as might be appropriate. The order also suspended all charges to operating expense accounts made by New York on or after January 1, 1943, for the purpose of or in conjunction with amortizing or otherwise disposing of amounts included in Account 100.4, pending submission of proof by respondent of the propriety and reasonableness of such charges.[8]

A joint hearing was then held with the New York Public Service Commission, and in June, 1943, the Federal Communications Commission issued its proposed report. After oral argument before the Commission sitting en banc, a final report and order were issued on December 14, 1943. 52 P. U. R. (N. S.) 101. The order directed New York to charge $4,166,510.57 to its Account 413, Miscellaneous Debits to Surplus, and to make appropriate concurrent entries to other accounts.[9]

New York then brought this suit before a district court of three judges to enjoin the Commission's order.[10] Appellant's motion for summary judgment was denied and on January 2, 1945, as has been said, the District Court entered its judgment permanently enjoining the order. 56 F. Supp. 932. The court held that the accounting entries were legal when made, since they were in accordance with the accounting system then prescribed by the Interstate Commerce Commission; and that, consequently, the Commission could "not apply retroactively a new system to write down the plaintiff's surplus." The court also held that the Commission's order was contrary to this Court's decision in *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232, and to a "stipulation" filed in that cause by the Solicitor General. The present appeal followed.

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[8] The Commission's order was grounded upon the provisions of § 220(e) of the Communications Act. See note 4.

[9] On the same date the New York Public Service Commission also adopted its final report and reached the same conclusion. See note 1. We are informed by a brief amicus curiae filed by the New York Public Service Commission that "a proceeding for the review of the order of the New York Commission has been brought in the Appellate Division of the Supreme Court of the State of New York but the argument thereof has been deferred pending the decision by this Court in the present case."

[10] Section 402(a) of the Communications Act makes applicable to orders of the Federal Communications Commission, with certain exceptions, the Urgent Deficiencies Act. 38 Stat. 219, 220.

Appellee's first argument in support of the District Court's decision is a simple one. It is, shortly, that the Commission's order was premised upon the conclusion that the original accounting entries were illegal when made. Appellee disputes this, maintaining that the accounting entries made prior to January 1, 1937, were in full accordance with the system of accounts prescribed by the Interstate Commerce Commission. That system, by the argument, was based not upon original cost but upon actual cost "without distinction between acquisitions from affiliated companies and acquisitions from other than affiliates."[11]

The answer to this contention is equally simple. It is not necessary to decide whether the accounting entries, when made, were legal under the system promulgated by the Interstate Commerce Commission; for we think the order in review was not based exclusively upon that premise. It is true that language in the Commission's report, when read out of context, might be taken to lend support to appellee's position. But the report, read as a whole, shows that the Commission's order for the readjustment of the accounts went on the view that the inflation was not justifiable in the light of its own original cost system of accounts. The Commission may have thought, as an alternative ground for its decision, that the accounts were illegal when made;[12] but the principal foundation of the order was that appellee was legally subject to the requirement of restating its accounts on the basis of original cost;[13] and consequently any excess on its books over American's net book cost must be eliminated.

We turn therefore to New York's further argument, which

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[11] The District Court apparently accepted this argument, for it said: "The order under review proceeds upon the theory that plaintiff's account in question was improper when made and should be corrected." 56 F. Supp. at 938.

[12] Cf. Opinion of the Public Service Commission of New York holding, in part, that the Interstate Commerce Commission accounting requirements did not oblige New York "to write up the book value of system property or to inflate surplus by intra-system profits. But the adroit companies found it a convenient excuse for inflating book values." 1 Report of the Public Service Commission (1943) 569, 587.

[13] See American Telephone & Telegraph Co. v. United States, 299 U. S. 232, 242: "We are not impressed by the argument that the classification is to be viewed as arbitrary because the fate of any item, its ultimate disposition, remains in some degree uncertain until the Commission has given particular directions with reference thereto. By being included in the adjustment account, it is classified as provisionally a true investment, subject to be taken out of that account and given a different character if investigation by the Commission shows it to be deserving of that treatment."

begins with a concession. The brief admits that the Commission "could require *the balances remaining* in appellee's property accounts to be reclassified." (Emphasis added.) But it is urged that the Commission properly can go no further. Since portions of the property have been retired and written out of the plant account at the amount at which they were recorded originally and since corresponding charges have been made concurrently to the depreciation reserve,[14] appellee says the Commission is without power, perhaps under the terms of the Communications Act, but at any rate under its own system of accounts, to order a reclassification of the entries for plant which has now been retired.

The Government answers that the effect of the write-up caused originally by New York's recording the property at structural value rather than at American's net book cost has never been eradicated. It points to the fact that New York did not apply a special depreciation rate to the property in question although it was not new and its price purported to reflect existing depreciation. Thus, the Government in effect asserts that there has been an under-depreciation.[15] New York denies this. It says that the group method,[16] under which the property was depreciated at rates similar to those applying to like property, takes into account the fact that some property may remain in service for a shorter time than is expected and that some property may remain serviceable for a long time. Under the group method, it insists, such inequalities are averaged out in the rate fixed for the group as a whole.

The effect of appellee's argument would be to render the Commission powerless to write off much of the inflation caused by the original accounting in this case. For, as has been pointed out, the inflation is not "removed as property is retired. . . . When property is retired its cost is credited to the proper asset account and (neglecting the effect of salvage) the same cost is debited

[14] See text at note 3.

[15] The brief amicus curiae of the New York Public Service Commission states: "A write-up or inflation of the net book cost may be brought about either by an inflation of the book cost figure on the asset side or by a reduction of the related depreciation figure on the liability side.

"In this case, the inflation was accomplished principally by an understatement of the related depreciation."

[16] See text at note 3.

to depreciation reserve, and the resultant change in book value is zero. Thus the effect of retiring an inflationary asset item is to create a deficiency in depreciation reserve equal to the inflation formerly existing in the asset account."[17]

Moreover, it would seem clear that rates established under the group method of depreciation are not properly applied to property purchased which is *known* not to have as long an expected serviceable life as property of the same sort purchased when new. It is true that testimony appears in the record that at the time of the purchase of the property "the question of the effect of this purchase on the depreciation rates, and whether or not the depreciation rates should be increased so [as] to allow for the fact that the property purchased was not new and, therefore, had less than the full life remaining" arose and was considered. True also, testimony showed it was decided at the time "that without any increase in the rates the rates that were already in effect would be ample to provide for retirement of the property purchased." Nevertheless the Commission apparently found that such was not the case.

We cannot say that such a conclusion was erroneous.[18] And it may be added, in support of the Commission's desire to put New York's accounts on an original cost basis, that one of the effects of original cost accounting will be not to require New York in the future to do what it should have done in the past, at least under the Federal Communications Commission system of ac-

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[17] Opinion of the New York Public Service Commission, 1 Report of the Public Service Commission (1943) 569, 590.

[18] The Commission stated: "New York attempted to counter these conclusions with the contention that its depreciation reserve *as a whole* is now in excess of requirements and consequently the inflation introduced through the accounting for the transactions in question has been offset by an excess in the reserve resulting from other causes; and that, further, unless the Commission can show that the reserve as a whole is deficient no correcting entry which would increase the reserve can be required. But the question as to whether the depreciation reserve, taken as a whole, is adequate is irrelevant to the issues herein. No challenge is here being made to the adequacy of the depreciation reserve as a whole. This line of argument represents an attempt to offset one error by another. If New York's depreciation reserve is in excess of requirements, it means that New York has been making excessive charges to operating expenses for depreciation." 52 P. U. R. (N. S.) 101, 116-117.

It has been urged that, even if the Federal Communications Commission was correct in ordering the inflation in the accounts of New York written off the books, that inflation has been reduced by some fraction of the depreciation previously taken, that is, prior to elimination of the inflation, even though the group method of depreciation was employed. That point, whatever its merits, was not made until the case reached this Court. Accordingly we do not consider it.

counts. " . . . The depreciation rate [under original cost accounting] applicable to a specific class of plant can be based on an estimate of total service life. There is no necessity to depreciate part of the account (constructed plant) on a total service life basis and another part (acquired properties) on a remainder life basis."[19]

Appellee further urges that so much of the Commission's order as affects property already retired is improper, because the sole purpose of original cost accounting is to show separately the amount by which the price paid by the accounting company for property now in service exceeded the original cost of that property. But the purposes of an original cost system of accounting are broader. Under such a system the inflation in accounts not only may be segregated but may also be written off.[20] *Northwestern Elec. Co.* v. *Federal Power Commission*, 321 U. S. 119, 123-124; *California Oregon Co.* v. *Federal Power Commission*, 150 F. 2d 25, 27-28.

The final question is whether the order falls within the decision in *American Telephone & Telegraph Co.* v. *United States*, 299 U. S. 232. That case involved an attempt to set aside an order of the Federal Communications Commission prescribing a uniform system of accounts for telephone companies. The companies objected to the order's "original cost" provisions as preventing them "'from recording their actual investment in their accounts' with the result that the accounts might not fairly exhibit their financial situation to shareholders, investors, tax collectors and others." The Court replied that such a consequence would not be entailed, but that under the order only such an amount would be written off "as appears . . . to be a fictitious or paper increment." 299 U. S. at 240. However, to avoid possible misunderstanding and to give assurance to the companies, the Court requested the assistant attorney general appearing for the Government to reduce to writing his statement in that regard in behalf of the Commission. This he did, informing the Court that

[19] Colbert, Advantages of Original Cost Classification of Plant (1945) 35 Public Utilities Fortnightly 333, 343.

[20] For obvious reasons, the utility companies have not objected so much to the segregating of the difference between the cost to the accounting company of property acquired and original cost less depreciation as they have to removing this difference from the books. See Kripke, A Case Study in the Relationship of Law and Accounting: Uniform Accounts 100.5 and 107 (1944) 57 Harv. L. Rev. 433, 438 ff., especially at 445.

"the Federal Communications Commission construes the provisions of Telephone Division Order No. 7-C, issued June 19, 1935, pertaining to account 100.4" as meaning "that amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization." This statement the Court accepted "as an administrative construction binding upon the Commission in its future dealings with the companies." The Court also noted that the case was to be distinguished from *New York Edison Co. v. Maltbie*, 244 App. Div. 685, aff'd, 271 N. Y. 103, "where under rules prescribed by the Public Service Commission of New York, there was an inflexible requirement that an account similar in some aspects to 100.4 be written off in its entirety out of surplus, whether the value there recorded was genuine or false."

The District Court thought the order in the instant case was erroneous "in view of the stipulation of these same defendants made in American T. & T. Co. v. United States, supra; certainly in the absence of proof that the excess of price over the seller's net book cost was not a 'true increment of value.' There has not been any determination based upon a fair consideration of all the circumstances in accordance with the stipulation mentioned, nor upon the evidentiary circumstances referred to in the opinion of the Supreme Court." 56 F. Supp. at 938.

We think this misconceives the "stipulation's" purport and effect. When the Federal Communications Commission finds, after full hearing and on evidence which sustains the finding, that part of the cost on the books of a company is due to a profit made by an affiliate or a parent at the time when the affiliate or parent has transferred property to it, the Commission has determined, "after a fair consideration of all the circumstances" in full compliance with the "stipulation's" reservation that there has been no true investment but only a "fictitious or paper increment" within the meaning of the *American Telephone and Telegraph Company* case.[21] The stipulation did not foreclose, rather it in

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[21] All relevant facts pertaining to the transaction were before the Commission. The Commission found that there was no real increment of value to the assets as a result of the transfer and that the inclusion of any write-up

terms reserved this inquiry. "For an intercorporate profit which upon a consolidated income statement of the affiliated group would disappear entirely is too lacking in substance to be treated as an actual cost." *Pennsylvania Power & Light Co.* v. *Federal Power Commission,* 139 F. 2d 445, 450. Indeed the opinion in the *American Telephone and Telegraph Company* case said: "There is widespread belief that transfers between affiliates or subsidiaries complicate the task of rate-making for regulatory commissions and impede the search for truth. Buyer and seller in such circumstances may not be dealing at arm's length, and the price agreed upon between them may be a poor criterion of value." 299 U. S. at 239.

It is argued, however, that the use of the word "may" was intended to put the burden on the Commission to find that in such inter-affiliate or parent-subsidiary transactions the price actually was a poor criterion of value. That is not our understanding. In the first place, the Act imposes upon the company, not on the Commission, the burden of proof to justify accounting entries. Neither the Court nor the Commission, in action taken with relation to the "stipulation," can be thought to have undertaken to shift this burden in the teeth of the statutory provision, as the full terms of the "stipulation," set forth below,[22] disclose.

would introduce "inflationary elements" into the plant accounts which in time would be "improperly reflected in the depreciation expense account as an alleged operating cost." No other findings were necessary. And the rejection by the Commission of the company's contention that reproduction cost less depreciation was the true criterion of "value" was plainly no error of law.

[22] The entire statement (sometimes called "stipulation") of the Government in the *American Telegraph & Telephone Company* case (exhibit 3 in the instant case) reads as follows:

"The Federal Communications Commission construes the provision of Telephone Division Order No. 7-C, issued June 19, 1935, pertaining to account 100.4, as follows:

"(1) That amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4 provision will be made for their amortization.

"(2) That when amounts included in account 100.4 are deemed, after a fair consideration of all the circumstances, to be definitely attributable to depreciable telephone plant, provisions will be made for amortization of such amounts through operating expenses, through the medium of either account 613 (R. 186) or account 675 (R. 205).

"The Commission believes that the foregoing construction of its order is that which it presented to the District Court through the affidavits of its witnesses:"

We think that the use of the conditional was meant to indicate no more than that this Court was not taking sides in the debate in accounting circles as to whether the price agreed upon between affiliates was or was not in fact a poor criterion of value. To resolve that discussion was and is for the regulatory commissions and not for the courts. We repeat that for a court to upset an accounting order it must be " 'so entirely at odds with fundamental principles of correct accounting' . . . as to be the expression of a whim rather than an exercise of judgment." 299 U. S. at 236-237. The order in this case is not of that character.[23]

The judgment is

Reversed.

[23] The Federal Power Commission, the Securities and Exchange Commission, and some state commissions (see the opinion of the New York Public Service Commission in the instant case) have taken the same position concerning interaffiliate transactions as has the Federal Communications Commission. See Kripke, A Case Study in the Relationship of Law and Accounting: Uniform Accounts 100.5 and 107 (1944) 57 Harv. L. Rev. 693, 705-708.

Mr. Chief Justice STONE is of opinion that the judgment should be affirmed on the ground, as the court below held, that petitioner, the Federal Communications Commission, is bound by and has not complied with the stipulation to which it was a party and which this Court approved in *American Tel. & Tel. Co.* v. *United States*, 299 U. S. 232, 240, 241. In that case it was contended that the Federal Communication Commission's uniform system of accounts for telephone companies would require that all amounts representing excess of purchase price paid by the telephone company to its parent company over the seller's original cost be written off.

The Court held that under that system, applied to the account here in question, which had been lawfully established under Interstate Commerce Commission regulations, only such amount could be written off as appeared "to be a fictitious or paper increment", and not "a true increment of value." To avoid "the chance of misunderstanding and to give adequate assurance to the companies [including respondent here] as to the practice to be followed," the Court requested the Assistant Attorney General to reduce his statements to that effect to writing in behalf of the Commission. He did this and informed the Court "that 'the Federal Communications Commission construes the provisions of Tele-

phone Division Order No. 7-C, issued January 19, 1935, pertaining to account 100.4' as meaning 'that amounts included in account 100.4 that are deemed, after a fair consideration of all the circumstances, to represent an investment which the accounting company has made in assets of continuing value will be retained in that account until such assets cease to exist or are retired; and, in accordance with paragraph (C) of account 100.4, provision will be made for their amortization.' ".

Before the Commission could rightly direct that the assets in that account, which have not been retired, be written off, the stipulation required it to find, after a "fair consideration of all the circumstances" that the difference between the original cost and the price claimed to have been paid is not "a true increment of value". This the Commission has not done. In the face of its stipulation it may not assume, without a finding based upon evidence, that there is no "true increment of value" to the assets which respondent purchased over the cost to the seller, merely because respondent purchased the assets from its parent corporation.

The judgment should be affirmed.

Mr. Justice BLACK, Mr. Justice REED and Mr. Justice JACKSON took no part in the consideration or decision of this case.